

REPORT OF EXAMINATION  
OF THE  
ZENITH INSURANCE COMPANY  
  
AS OF  
DECEMBER 31, 2008

Participating State  
and Zone:

California

Filed June 9, 2010

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Los Angeles, California  
May 21, 2010

Honorable Alfred W. Gross  
Chairman of the NAIC Financial  
Condition Subcommittee  
Commissioner of Insurance  
Virginia Bureau of Insurance  
Richmond, Virginia

Honorable Christina Urias  
Secretary, Zone IV-Western  
Director of Insurance  
Arizona Department of Insurance  
Phoenix, Arizona

Honorable Steve Poizner  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman, Secretary, and Commissioner:

Pursuant to your instructions, an examination was made of the

#### ZENITH INSURANCE COMPANY

(hereinafter also referred to as the Company) at the statutory home office and primary location of its books and records, 21255 Califa Street, Woodland Hills, California 91367.

#### SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2005. This examination covers the period from January 1, 2006 through December 31, 2008. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination was conducted concurrently with the examination of the Company's subsidiary, ZNAT Insurance Company. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2008, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states; loss experience; accounts and records; and sales and advertising.

### SUBSEQUENT EVENTS

On May 20, 2010, the Company's parent Zenith National Insurance Corp. (ZNIC) merged with Fairfax Financial Holdings Limited (Fairfax). Under the merger agreement, Fairfax acquired all of the outstanding shares of ZNIC common stock which it did not currently own for \$38.00 per share in cash.

### COMPANY HISTORY

On May 24, 2006 the Company's parent, Zenith National Insurance Corp. (ZNIC), transferred the ownership of its airplane to the Company. The transaction was recorded as a capital contribution in the amount of \$8.5 million, the estimated fair value of the airplane. However, the airplane was non-admitted by the Company, thus the transaction did not affect the surplus of the Company.

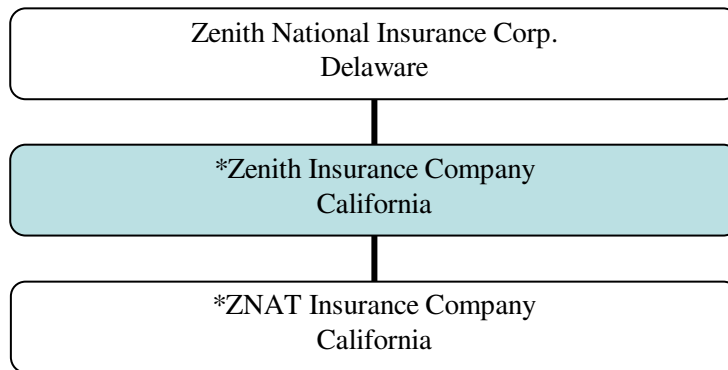
During 2008, the Company recorded \$5.2 million as paid in surplus in connection with a restricted stock plan approved by ZNIC stockholders. The transaction was recorded in accordance with Statement of Statutory Accounting Principle No. 13.

During the examination period, the Company declared and paid the following ordinary cash dividends to its parent, ZNIC:

<u>Year</u>	<u>Amount</u>
2006	\$ 50,000,000
2007	115,000,000
2008	<u>95,000,000</u>
Total	\$260,000,000

### MANAGEMENT AND CONTROL

The following abridged organizational chart, which is limited to the Company's parent along with its subsidiary insurance companies, depicts the Company's relationship within the holding company system:



(\*) all ownership is 100%

Management of the Company is vested in a nine-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2008 follows:

### Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Max M. Kampelman Washington, District of Columbia	Attorney, of Counsel Fried, Frank, Harris, Shriver, and Jacobson, LLP
Robert J. Miller Las Vegas, Nevada	Attorney, Principal Dutko Worldwide
Fabian Nuñez Sacramento, California	Partner and Co-Chair Mercury Public Affairs LLC
Leon E. Panetta(*) Carmel Valley, California	Founder and Director The Leon & Sylvia Panetta Institute for Public Policy
Catherine B. Reynolds Sterling, Virginia	Chairman and Chief Executive Officer The Catherine B. Reynolds Foundation
Alan I. Rothenberg Los Angeles, California	Attorney, Chairman and Chief Executive Officer 1 <sup>st</sup> Century Banchares, Inc.
William S. Sessions Washington, District of Columbia	Attorney Holland and Knight LLP
Michael W. Zavis Boca Raton, Florida	Attorney Retired
Stanley R. Zax Beverly Hills, California	Chairman of the Board and President Zenith National Insurance Corp.

(\*) resigned February 2, 2009, replaced by Jerome L. Coben, Attorney:Partner, Zeughauser Group

### Principal Officers

<u>Name</u>	<u>Title</u>
Stanley R. Zax	Chairman of the Board
Jack D. Miller	President
Michael E. Jansen	Executive Vice President and General Counsel
Davidson M. Pattiz	Executive Vice President
Keith E. Trotman	Executive Vice President
Kari L. Van Gundy	Executive Vice President, Chief Financial Officer and Treasurer
Robert E. Meyer	Executive Vice President and Chief Actuary
Hyman J. Lee Jr.	Vice President and Secretary

### Management Agreements

Administrative Services and Cost Sharing Agreement (Agreement): Zenith National Insurance Corp. (ZNIC) and its insurance subsidiaries are parties to the Agreement dated January 1, 2008. The Agreement terminates, supersedes and replaces the Cost Allocation Agreement which had been in effect since 1991. On October 9, 2008, Amendment No. 1 was entered into and added Zenith Insurance Management Services, Inc., a Florida corporation and a wholly-owned non-insurance subsidiary of the Company, as a party to the Agreement. Under the terms of the Agreement, costs of shared facilities, services, and expenses are allocated to each party on a cost allocation basis using actual and reasonable costs. During the years 2006, 2007, and 2008, the Company received \$18.0 million, \$38.0 million, and \$41.5 million, respectively, in fees from its affiliates under the terms of the Agreement. On February 21, 2008 and October 2, 2008, the California Department of Insurance (CDI) approved the Agreement and Amendment No.1, respectively.

Tax Sharing Agreement: The Company and certain affiliates are parties to a tax sharing agreement. The agreement provides for participants to file a consolidated federal income tax return with ZNIC. Allocation of taxes is based upon separate return calculations with intercompany tax balances settled in the quarter subsequent to the filing of the consolidated return. The agreement and its amendment dated October 30, 2006 were approved by the CDI on December 19, 2006.

## TERRITORY AND PLAN OF OPERATION

As of December 31, 2008, the Company was licensed to transact multiple lines of property and casualty insurance in the District of Columbia and the following states:

Alabama	Hawaii	Massachusetts	New York	Texas
Alaska	Idaho	Michigan	North Carolina	Utah
Arizona	Illinois	Minnesota	Ohio	Vermont
Arkansas	Indiana	Mississippi	Oklahoma	Virginia
California	Iowa	Missouri	Oregon	Washington
Colorado	Kansas	Montana	Pennsylvania	Wisconsin
Connecticut	Kentucky	Nebraska	Rhode Island	
Delaware	Louisiana	Nevada	South Carolina	
Florida	Maine	New Jersey	South Dakota	
Georgia	Maryland	New Mexico	Tennessee	

In 2008, the Company wrote \$527 million of direct premiums. Of the direct premiums written, \$247 million (47%) was written in California, \$152 million (29%) was written in Florida, \$30 million (6%) was written in Texas and \$98 million (18%) was written in the remaining states. The only line of business written by the Company is workers' compensation.

The Company's business is written through approximately 1,600 independent licensed insurance agents. The Company and its insurance subsidiary, ZNAT Insurance Company, maintain branch offices in Fresno, Glendale, Los Angeles, Orange, Pleasanton, Sacramento, San Diego, Santa Cruz, and Solana Beach, California. Additionally, the companies maintain branch offices in Birmingham, Alabama; Hollywood, Orlando, and Sarasota, Florida; Lisle and Springfield, Illinois; Charlotte, North Carolina; Blue Bell, Pennsylvania; and Austin, Texas.

## GROWTH OF COMPANY

The Company reported significant decreases in direct and net premiums written and a significant increase in surplus during the years under examination as follows:

<b>Year</b>	<b>Direct Premiums Written</b>	<b>Net Premiums Written</b>	<b>Surplus</b>
<b>2009</b>	\$405,469,483	\$442,970,981	\$ 979,163,633
<b>2008</b>	527,029,243	578,631,614	1,015,329,561
<b>2007</b>	626,802,213	703,140,464	451,094,649
<b>2006</b>	735,611,640	871,950,971	559,503,808

The decrease in premiums written is related to two factors: the decrease in rates and payrolls due to the state of the economy and to the increased competition within the workers' compensation insurance market. The increase in surplus during 2008 was primarily the result of the elimination of \$570 million excess statutory reserve for the workers' compensation line of business. Effective January 1, 2008, California enacted legislation (Senate Bill 316) to eliminate the excess statutory reserves required by California Insurance Code Section 11558.

## REINSURANCE

### Intercompany Pooling Agreement

The underwriting operations of the Company, and its insurance subsidiary ZNAT Insurance Company (ZNAT), are governed by an Intercompany Pooling Agreement (Pooling Agreement). The Pooling Agreement provides for the pooling and distribution, in fixed percentages, of the companies' underwriting operations, liabilities, expenses, income, and losses directly related to the writing of insurance contracts. Excluded from the Pooling Agreement are intercompany balances, real estate expenses, investment income and expenses, and directors' fees and similar expenses.

The Company is the lead insurer in the pool. Under the terms of the Pooling Agreement, ZNAT cedes to the Company 100% of its net retained underwriting liabilities. The Company then retrocedes to ZNAT its proportionate share of the pooled underwriting liabilities. Members of the pool and their respective participation percentages as of year-end 2008 were as follows:

<u>Pool Member</u>	<u>Percentage</u>
Zenith Insurance Company	98%
ZNAT Insurance Company	2%
Total	<u>100%</u>

Both parties to the Pooling Agreement are named participants in all reinsurance agreements with non-affiliated reinsurers, and have a contractual right of direct recovery from the non-affiliated reinsurers.

#### Assumed

Other than the pooling agreement mentioned above and certain mandatory reinsurance pools, the Company has an immaterial amount of reinsurance assumed as they exited the assumed reinsurance business in September, 2005.

#### Ceded

As of year-end 2008, the Company maintained excess of loss and catastrophe reinsurance protection on its direct workers' compensation writings as follows: Excess of loss reinsurance covering losses, per occurrence, in excess of \$5 million up to an aggregate loss of \$150 million and up to \$200 million for catastrophe losses arising out of California earthquakes. The following is a summary of the principal ceded reinsurance treaties in-force as of December 31, 2008:

Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Maximum Limits
First – Fourth Layer	100% Employer Reinsurance Corporation (Westport Insurance Company)	\$5 million	\$5 million Excess of \$5 million
Fifth Layer	16.75% Various Lloyd's of London Syndicates 11.25% Hannover Rueckversicherungs – AG 72% Various reinsurers	\$10 million	\$10 million Excess of \$10 million
Sixth Layer	18.7% Various Lloyd's of London Syndicates 17.5% Hannover Rueckversicherungs – AG 15% Swiss Re America Corp. 12% Axis Specialty Limited 10% Arch Reinsurance Company 10% Transatlantic Reinsurance Company 16.8% Various reinsurers	\$20 million	\$20 million Excess of \$20 million
Seventh Layer	24% Various Lloyd's of London Syndicates 10% Ace Tempest Reinsurance Limited 10% Platinum Underwriters Bermuda Ltd. 56% Various reinsurers	\$40 million	\$35 million Excess of \$40 million
Eighth Layer	15% Axis Specialty Limited 14.6% Various Lloyd's of London Syndicates 13.4% Aspen Insurance UK Limited 13% Ace Tempest Reinsurance Limited 12.5% Swiss Re America Corp. 10% Platinum Underwriters Bermuda Ltd. 21.5% Various reinsurers	\$75 million	\$75 million Excess of \$75 million
California Earthquake Only	25% Various Lloyd's of London Syndicates 17.5% Swiss Re America Corp. 17.5% Aspen Insurance UK Limited 10% Allied World Insurance Company 30% Various reinsurers	\$150 million	\$50 million Excess of \$150 million
Nuclear, Biological, Chemical or Radiological	50% Lloyd's Syndicate 2987 BRT 30% Platinum Underwriters Bermuda Ltd 20% Houston Casualty Company	\$10 million	\$20 million Excess of \$10 million

The Company's reinsurance program also provides protection for acts of terrorism both domestic and foreign.

As of December 31, 2008, reinsurance recoverables, for all ceded reinsurance totaled \$266 million, or 26% of surplus as regards policyholders, with \$248 million of the reinsurance recoverables from non-affiliated admitted reinsurers.

### RISCORP, Inc. Acquisition

Pursuant to an Asset Purchase Agreement that was approved by the California Department of Insurance on March 31, 1998, the Company acquired substantially all of the assets and certain liabilities of RISCORP, Inc. (RISCORP) and its subsidiaries related to its workers' compensation business. In connection with the acquisition, the Company entered into an aggregate excess of loss reinsurance agreement with Inter-Ocean Reinsurance Company, Ltd. (Inter-Ocean) on August 1, 1998, which provides ceded reinsurance for unpaid loss and allocated loss adjustment expenses assumed from RISCORP at April 1, 1998 up to \$50 million in excess of \$182 million. The Company paid \$16.0 million for the coverage. The agreement has been accounted for as retroactive reinsurance as required under the Statements of Statutory Accounting Principles No. 62. As of December 31, 2008 the surplus gain was approximately \$17.6 million.

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2008

Underwriting and Investment Exhibit for the Year Ended December 31, 2008

Reconciliation of Surplus as Regards Policyholders  
from December 31, 1995 through December 31, 2008

Statement of Financial Condition  
as of December 31, 2008

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$1,612,619,551	\$	\$1,612,619,551	
Stocks:				
Preferred stocks	4,704,882		4,704,882	
Common stocks	74,412,720		74,412,720	
Real Estate:				
Properties occupied by the company	16,053,042		16,053,042	
Cash, cash equivalents and short-term investments	144,009,273		144,009,273	
Other invested assets	74,769,726		74,769,726	
Receivables for securities	5,734		5,734	
Investment income due and accrued	22,839,920		22,839,920	
Premiums and considerations:				
Uncollected premiums and agents' balances in the course of collection	7,125,037	458,704	6,666,333	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	2,798,637	215,484	2,583,153	
Amounts recoverable from reinsurers	2,599,817		2,599,817	
Funds held by or deposited with reinsured companies	893,902		893,902	
Other amounts receivable under reinsurance contracts	996,176		996,176	
Current federal and foreign income tax recoverable and interest thereon	32,522,000		32,522,000	
Net deferred tax asset	60,472,000		60,472,000	
Guaranty funds receivable or on deposit	20,828,005		20,828,005	
Electronic data processing equipment and software	8,791,821	6,768,399	2,023,422	
Furniture and equipment, including health care delivery assets	19,806,760	19,806,760		
Receivables from parent, subsidiaries and affiliates	11,059,875		11,059,875	
Aggregate write-ins for other than invested assets	<u>22,151,222</u>	<u>5,761,861</u>	<u>16,389,361</u>	
Total assets	<u>\$2,139,460,100</u>	<u>\$ 33,011,208</u>	<u>\$2,106,448,892</u>	

Liabilities, Surplus and Other Funds

Losses	\$ 775,394,518	(1)
Reinsurance payable on paid losses and loss adjustment expenses	546,387	
Loss adjustment expenses	210,082,821	(1)
Commissions payable, contingent commissions and other similar charges	6,673,122	
Other expenses	10,214,835	
Taxes, licenses and fees	39,895,159	
Unearned premiums	44,162,804	
Advance premium	2,343,611	
Ceded reinsurance premiums payable	297,314	
Funds held by company under reinsurance treaties	34,777	
Amounts withheld or retained by company for account of others	2,607,859	
Provision for reinsurance	1,308,779	
Payable for securities	17,123	
Aggregate write-ins for liabilities	<u>(2,459,778)</u>	
Total liabilities	1,091,119,331	
Aggregate write-ins for special surplus funds	\$ 13,410,745	
Common capital stock	4,200,000	
Gross paid-in and contributed surplus	307,738,108	
Unassigned funds (surplus)	<u>689,980,708</u>	
Surplus as regards policyholders	<u>1,015,329,561</u>	
Total liabilities, surplus and other funds	<u>\$2,106,448,892</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2008

Statement of Income

Underwriting Income

Premiums earned		\$ 595,179,850
Deductions:		
Losses incurred	\$ 190,489,578	
Loss adjustment expenses incurred	83,821,038	
Other underwriting expenses incurred	<u>221,337,542</u>	
Total underwriting deductions		<u>495,648,158</u>
Net underwriting gain		99,531,692

Investment Income

Net investment income earned	\$ 91,502,530	
Net realized capital losses	<u>(10,517,223)</u>	
Net investment gain		80,985,307

Other Income

Net loss from agents' or premium balances charged off	\$ (1,395,390)	
Aggregate write-ins for miscellaneous income	<u>30,723</u>	
Total other income		<u>(1,364,667)</u>
Net income before dividends to policyholders and before federal income taxes		179,152,333
Dividends to policyholders		14,089,127
Federal income taxes incurred		<u>53,587,066</u>
Net income		<u>\$ 111,476,140</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2007		\$ 451,094,649
Net income	\$ 111,476,140	
Net unrealized capital losses	(10,449,234)	
Change in net unrealized foreign exchange capital loss	(8,535,604)	
Change in net deferred income tax	(7,032,000)	
Change in nonadmitted assets	(515,564)	
Change in provision for reinsurance	56,679	
Surplus adjustment: Paid-in	5,218,045	
Dividends to stockholders	(95,000,000)	

Aggregate write-ins for gains and losses in surplus	<u>569,016,450</u>	
Change in surplus as regards policyholders		<u>564,234,912</u>
Surplus as regards policyholders, December 31, 2008		<u><u>\$1,015,329,561</u></u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2005 through December 31, 2008

Surplus as regards policyholders, December 31, 2005, per Examination			\$ 440,849,957
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 622,852,571	\$	
Net unrealized capital losses		1,790,359	
Change in net unrealized foreign exchange capital loss		2,931,302	
Change in net deferred income tax		25,319,000	
Change in nonadmitted assets		9,620,779	
Change in provision for reinsurance	507,288		
Surplus adjustments: Paid-in	13,718,045		
Dividends to stockholders		260,000,000	
Change in excess statutory reserves	239,768,018		
Aggregate write-ins for losses in surplus	<u>                    </u>	<u>2,704,878</u>	
Totals	<u>\$ 876,845,922</u>	<u>\$302,366,318</u>	
Net increase in surplus as regards policyholders for the examination period			<u>574,479,604</u>
Surplus as regards policyholders, December 31, 2008, per Examination			<u>\$1,015,329,561</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2008 were found to be reasonably stated and have been accepted for purposes of this examination.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

None.

### Previous Report of Examination

None.

## ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

\_\_\_\_\_/S/\_\_\_\_\_  
Gregory J. Lieber, CFE  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California